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# Outlook for the Economy and Real Estate

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## The Outlook for The Economy and Real Estate

Growth of real or inflation adjusted Gross National Product (GNP) during the first quarter has been revised down to 2.9 percent from 3.7 percent due to less of an improvement in our foreign trade balance than previously reported. All of the first quarter growth was attributed to an accumulation of inventories, while final sales actually declined. The first quarter results, combined with recent economic indicators, strongly suggest that a major inventory correction took place during the second quarter, with real GNP expected to have increased only 1.7 percent. While the impacts of falling oil prices, a depreciating dollar and lower interest rates should boost overall economic activity during the second half of this year, there is growing evidence that the second half rebound will be more modest than previously expected. At this point growth rates of about three percent are expected during the third and fourth quarters, resulting in growth for all of 1986 of 2.3 percent. A major factor in this scaling back of growth during the second half is that our forecast now assumes enactment of tax reform legislation similar to that passed by the Senate later this year to be effective on January 1, 1987. Subsequently, both residential and nonresidential investment spending are weakened over the remainder of this year and the rest of the forecast horizon. Growth of real GNP should remain at about two percent during 1987 and 1988 as tax reform dampens investment spending at the same time that this economic recovery is weakening with age.

Production has been reduced during the second quarter to correct the inventory imbalance created earlier this year. This weakness in production, combined with sharp cutbacks in the hard-hit energy industry, have intensified the sluggishness of the domestic manufacturing sector which has yet to benefit from the depreciation of the dollar. Recent monthly figures underscore these trends. Employment in manufacturing and mining declined by 70,000 jobs in May. Industrial production declined 0.6 percent and the capacity utilization rate of the nation's factories fell below 79 percent largely reflecting cutbacks in auto production and in oil and gas drilling. However, while domestic production has been scaled back the consumer continues to spend. A surge in auto sales due to cut-rate financing incentives buoyed overall consumption in May, while a strong housing market has boosted residential investment and consumer demand for furniture and other household durables. Therefore, while the increase in final sales should add about 3.9 percentage points tc real GNP growth for the second quarter, the depletion of inventories should subtract about 2.2 percentage points from growth for a net growth rate for the quarter of about 1.7 percent.

It was earlier believed that the positive impacts of lower oil prices, a declining dollar, and falling interest rates would lift the economy out of its current doldrums during the second half of this year. However, recent monthly indicators show no real momentum building. For example, the Index of Leading Economic Indicators rose a modest 0.2 percent in May. Further, the all but certain passage of tax reform legislation later this year should further dampen this rebound as businesses scale back already modest investment spending. While lower oil prices have had and will continue to have positive effects on the economy, many analysts have underestimated the negative effects of lower oil prices in the form of cuts in domestic oil production and sharply scaled back investment plans by domestic energy firms. The positive effects of the depreciating dollar may also be slower to materialize than previously expected as the trade deficit rose in May. U.S. exports are expected to improve during the last half of this year but these gains will lead to only modest improvement in the trade deficit and should not make a major contribution to economic growth until 1987. While the stimulus from falling interest rates has boosted housing, overall investment, particularly multi-family housing and nonresidential structures, will be considerably dampened by tax reform. Given these developments the rebound in the last half of 1986 will be modest in both strength and duration with growth of about three percent expected followed by slower growth in 1987.

The downward pressure on inflation from the sharp drop in oil prices appears to have diminished. In May, the Consumer Price Index (CPI) increased 0.2 percent after declining a full 1.1 percent during the previous three months. Gasoline prices, which had declined 26.5 percent in the 3-month period ending in April, advanced 2.5 percent and were responsible for the reversal in this index in May. During the last half of 1986, as the effects of lower oil prices continue to subside, the underlying inflation that is present in the service sector of the economy will become more apparent in the monthly inflation figures. However, given the large declines in energy prices so far this year, the level of inflation for all of 1986 should be about two percent compared to 3-1/2 percent in 1985. By 1987, the upward pressure on prices of imports from a declining dollar should dominate the inflation picture, leading to a mild reacceleration of inflation with the CPI increasing about three percent.

The civilian unemployment rate increased 0.2 percentage points in May to 7.3 percent due mainly to layoffs in manufacturing and mining industries. Also contributing to the May increase was an inflow of college students into the labor force who have not yet been able to find a summer job. On the bright side, employment in construction and the service sector--especially finance and real estate--recorded healthy gains in May as lower interest rates continue to stimulate the housing industry. However, given the assumption of tax reform, the outlook for unemployment is not bright. By 1987, slower overall economic growth should reduce employment growth, pushing the unemployment rate to the upper seven percent range.

Monetary Policy and Interest Rates

As expected, interest rates have been edging downward over the past few weeks and have nearly returned to the levels of mid-April. Yields on 30-year Treasury bonds, which rose to about 7.9 percent by early June, are now back down to 7.2 percent. Similarly, yields on 3-month Treasury bills have dipped below six percent after rising to 6.4 percent in early June. Rates have declined in response to continued indicators of a sluggish economy and growing anticipation that the FED will further ease credit conditions in the next few weeks, including an additional cut in the discount rate from 6-1/2 percent to six percent, in order to spur the economy. There is also a growing expectation that this easing of credit conditions in the U.S. will be coordinated with similar actions in both Japan and West Germany as both countries experienced a decline in overall economic activity during the first quarter of this year. In fact, the Japanese economy contracted at an annual rate of 2.1 percent during the first quarter in response to the appreciation of the yen, the first quarterly decline in more than a decade.

With sluggish economic growth resulting in an easing of aggregate credit demand and the likelihood of further easing of monetary policy by the FED, interest rates are expected to continue to gradually trend downward over the remainder of 1986 and into 1987 and 1988. By the end of this year interest rates on 30-year fixed-rate mortgages, currently averaging about 10 percent, should decline to below 9-1/2 percent. Over the course of 1987 that interest rate should decline about another one-half percentage point.

While the further easing by the FED appears imminent, it should be noted that within the FED there appears to be substantial apprehension of the potentially inflationary impact of such action. M1, the nation's basic money supply of currency and checkable deposits, has been growing very rapidly this year and is well above the FED's target range. In recent months the broader measures of the money supply, M2 and M3, have also begun growing rapidly and are now approaching the top of their target ranges. Some members of the FED, particularly Chairman Paul Volcker, fear that such rapid growth of the money supply combined with the decline in the value of

the dollar could result in a major resurgence of inflation later this year or in 1987. Outweighing these fears, however, is the concern that the current sluggish growth of the economy could deteriorate into recession, particularly in view of the depressing effect of tax reform on business investment spending. For example, the two newest members of the Board of Governors, Vice Chairman Manuel Johnson and Wayne Angell, have stated publicly that they do not regard a resurgence of inflation as likely and are more concerned about the current weakness of the economy. Also, with just four months remaining before elections, Senate Majority Leader Dole has publicly expressed that interest rates need to be reduced to stimulate the economy. Under these circumstances, it appears that the FED will chose to err on the side of monetary ease.

The Federal Budget

House and Senate conferees have finally adopted a budget for FY87. While this budget does reach the Gramm-Rudman-Hollings deficit target of $144 billion, it is based on overly optimistic economic assumptions. Consequently, if growth of real GNP falls below the three percent rate assumed in congressional budget projections, which is highly likely, the deficit will exceed the target imposed by GRH and the automatic across-the-board spending cuts may be enforced. Further, the budget has failed to account for the effects of tax reform which is likely to have a dramatic impact on federal receipts over the next five years. In fact, by 1987, slower economic growth brought on by tax reform should lead to slower growth of federal tax revenues and cause the federal deficit to start increasing again. Any attempts to lower the deficit in 1988 through further cuts in spending would severely dampen growth of the economy so that Congress may abandon the GRH targets altogether.

Real Estate Markets

Existing single-family home sales remained robust in May as homebuyers continued to take advantage of the lowest mortgage interest rates in more than seven years. Resales proceeded at a 3.45 million unit annual pace, down slightly from April's 3.57 million pace but up nearly 14 percent from a year ago. New housing units were started at a seasonally adjusted annual rate of 1.888 million units in May, down from 2.039 million units in April but 12 percent ahead of a year ago. All of the decline in housing starts in May occurred in the multifamily category, probably reflecting the chilling effect of the Senate tax reform proprosal. The surge in housing demand has resulted in much faster rates of price appreciation. The median price of existing homes sold in May was $84,400, 12.2 percent above the median of May of 1985. This was the highest rate of appreciation recorded since November of 1980. Similarly, median price of new homes sold in May was 15 percent above the level of a year ago.

As interest rates are expected to edge down modestly over the remainder of this year and into 1987 and 1988, we would normally expect the resale market to continue to improve while housing starts should trail off slighly due to declining demographic demand. However, tax reform is likely to seriously disrupt housing markets. While roughly 600,000 multi-family housing starts are expected this year, they are likely to drop by about 25 percent to around 500,000 units in both 1987 and 1988. Single-family resales and starts are also likely to be depressed as homebuyers and lenders adjust to significant increases in after-tax homeownership costs. For all of 1986 about 3.5 million existing homes should be sold while about 1.25 million new single-family homes are started. In 1987 resales should remain at about 3.5 million units rather than rising to 3.6 million or higher as had been previously been expected. About 1.1 million single-family starts are expected in 1987, down about 150,000 units or 11 percent over the 1986 level. Home prices are also likely to be depressed as a result of tax reform so that rates of home price appreciation in 1987 and 1988 should be considerably lower than they otherwise would have been.

Table 1

July 1986

U.S. ECONOMIC OUTLOOK

| | QUARTERS | | | | | | | YEARS | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Actual | | Forecast | | | | | Actual | | Forecast | | |
| | 1985.4 | 1986.1 | 1986.2 | 1986.3 | 1986.4 | 1987.1 | 1987.2 | 1987.3 | 1984 | 1985 | 1986 | 1987 | 1988 |
| AGGREGATE ECONOMY | | | | | | | | | | | | | |
| Gross National Product | | | | | | | | | | | | | |
| (billions of dollars) | 4,059 | 4,116 | 4,154 | 4,217 | 4,275 | 4,316 | 4,352 | 4,386 | 3,775 | 3,989 | 4,190 | 4,372 | 4,582 |
| % Change | 4.3 | 5.7 | 3.8 | 6.2 | 5.6 | 4.0 | 3.4 | 3.4 | 11.0 | 5.7 | 5.1 | 4.3 | 4.8 |
| % Change (w/out inflation) | 0.7 | 2.9 | 1.7 | 3.3 | 3.2 | 1.7 | 0.9 | 0.8 | 6.6 | 2.2 | 2.3 | 1.9 | 1.9 |
| Consumption | 0.1 | 3.8 | 5.1 | 2.3 | 2.1 | 1.1 | 0.7 | 0.5 | 4.4 | 3.3 | 3.1 | 1.6 | 1.8 |
| Durables | -13.3 | -0.7 | 16.3 | 4.5 | 4.1 | -3.3 | -2.5 | -1.7 | 12.4 | 8.4 | 3.9 | 0.7 | 1.6 |
| Nondurables | 0.6 | 6.6 | 2.9 | 1.7 | 1.5 | 1.6 | 1.0 | 0.7 | 3.4 | 2.3 | 3.0 | 1.5 | 1.8 |
| Services | 4.4 | 3.1 | 3.4 | 2.1 | 2.0 | 2.1 | 1.5 | 1.1 | 3.0 | 2.5 | 2.9 | 1.9 | 1.9 |
| Residential Investment | 5.7 | 9.7 | 12.9 | 3.2 | 0.8 | -7.6 | -14.7 | -13.1 | 13.2 | 1.7 | 7.8 | -5.8 | -3.3 |
| Nonresidential Investment | 11.3 | -13.3 | 1.4 | 2.7 | 3.6 | -0.5 | -2.7 | -1.9 | 19.5 | 9.7 | 0.3 | 0.0 | -1.2 |
| Structures | 7.2 | -15.4 | -0.9 | 1.2 | 3.2 | 1.0 | 0.5 | 0.4 | 14.7 | 11.4 | -2.2 | 1.1 | 0.4 |
| Equipment | 13.5 | -12.1 | 2.6 | 3.5 | 3.8 | -1.2 | -4.3 | -3.1 | 22.2 | 8.8 | 1.6 | -0.5 | -2.0 |
| Exports | 6.6 | 6.6 | 6.1 | 5.4 | 6.2 | 6.2 | 6.8 | 6.7 | 6.2 | -3.0 | 3.6 | 6.3 | 5.6 |
| Imports | 24.5 | 2.4 | 3.1 | 0.9 | -0.1 | -2.3 | -4.0 | -5.1 | 22.8 | 2.7 | 8.2 | -2.0 | -2.9 |
| Government Purchases | 9.2 | -13.8 | -1.2 | 1.3 | 1.0 | 1.3 | 1.1 | 1.0 | 4.3 | 6.0 | 0.3 | 1.0 | 0.9 |
| Contribution to GNP Growth (Percentage Points) | | | | | | | | | | | | | |
| Consumption | 0.1 | 2.5 | 3.3 | 1.5 | 1.4 | 0.7 | 0.5 | 0.3 | 2.2 | 1.9 | 2.2 | 0.7 | 1.3 |
| Residential Investment | 0.3 | 0.5 | 0.6 | 0.2 | 0.0 | -0.4 | -0.8 | -0.7 | 0.2 | 0.3 | 0.3 | -0.6 | 0.2 |
| Nonresidential Investment | 1.4 | -1.9 | 0.2 | 0.3 | 0.5 | -0.1 | -0.3 | -0.2 | 1.9 | 0.5 | -0.2 | -0.3 | -0.1 |
| Structures | 0.3 | -0.8 | 0.0 | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 | 0.6 | 0.4 | -0.2 | 0.0 | 0.0 |
| Equipment | 1.1 | -1.1 | 0.2 | 0.3 | 0.3 | -0.1 | -0.4 | -0.3 | 1.3 | 0.5 | -0.1 | -0.3 | -0.1 |
| Inventory Change | -0.5 | 4.7 | -2.2 | 0.6 | 0.5 | 0.2 | 0.1 | -0.2 | 0.4 | -1.2 | 0.9 | 0.0 | 0.0 |
| Net Exports | -2.3 | 0.3 | 0.2 | 0.4 | 0.6 | 1.0 | 1.3 | 1.4 | -1.5 | -1.2 | 0.4 | 1.2 | 0.7 |
| Government Purchases | 1.8 | -3.0 | -0.2 | 0.3 | 0.2 | 0.3 | 0.2 | 0.2 | 1.5 | 1.5 | -0.7 | 0.2 | 0.2 |
| Mfg. Capacity Utilization Rate | 80.1 | 80.0 | 78.8 | 79.1 | 79.5 | 79.2 | 78.8 | 78.3 | 80.8 | 80.3 | 79.3 | 78.6 | 78.6 |
| Domestic Auto Sales | 7.0 | 7.9 | 7.9 | 7.5 | 7.7 | 7.8 | 7.6 | 7.3 | 8.0 | 8.3 | 7.8 | 7.5 | 7.1 |
| Personal Income Per Household | 40,531 | 41,053 | 41,329 | 41,667 | 42,013 | 42,389 | 42,700 | 42,986 | 38,175 | 40,029 | 41,508 | 42,851 | 44,477 |
| Percent Change -- Year Ago | 4.3 | 3.9 | 3.7 | 4.3 | 3.7 | 3.3 | 3.3 | 3.2 | 10.4 | 4.9 | 3.7 | 3.2 | 3.8 |
| Personal Taxes Per Household | 6,143 | 6,091 | 6,176 | 6,250 | 6,312 | 6,282 | 6,337 | 6,389 | 5,420 | 5,987 | 6,206 | 6,277 | 6,208 |
| Percent Change -- Year Ago | 8.9 | -0.5 | 10.8 | 3.4 | 2.8 | 3.1 | 2.6 | 2.2 | 12.2 | 10.5 | 3.6 | 1.2 | -1.1 |
| Percent of Personal Income | 15.2 | 14.8 | 14.9 | 15.0 | 15.0 | 14.8 | 14.8 | 14.9 | 14.2 | 15.0 | 15.0 | 14.6 | 14.0 |
| Disposable Personal Income Per Household | 34,388 | 34,962 | 35,153 | 35,417 | 35,701 | 36,107 | 36,362 | 36,598 | 32,755 | 34,042 | 35,302 | 36,574 | 38,269 |
| Percent Change -- Year Ago | 3.5 | 4.7 | 2.8 | 4.3 | 3.8 | 3.3 | 3.4 | 3.3 | 8.3 | 3.9 | 3.7 | 3.6 | 4.6 |
| Employment (millions) | 108.0 | 108.8 | 109.0 | 109.1 | 109.5 | 109.5 | 109.6 | 109.9 | 105.0 | 107.2 | 109.1 | 109.8 | 111.0 |
| (civilian household basis) | | | | | | | | | | | | | |
| % Change | 3.0 | 2.9 | 0.7 | 0.6 | 1.3 | 0.2 | 0.1 | 1.3 | 4.1 | 2.1 | 1.8 | 0.6 | 1.1 |
| Unemployment Rate (%) (civilian) | 7.0 | 7.1 | 7.1 | 7.3 | 7.2 | 7.4 | 7.6 | 7.7 | 7.5 | 7.2 | 7.2 | 7.7 | 7.9 |
| Consumer Prices (CPI) | 4.4 | 1.4 | -2.0 | 3.2 | 2.6 | 2.8 | 3.1 | 3.2 | 4.3 | 3.5 | 1.9 | 2.9 | 3.3 |
| GNP Deflator | 3.3 | 2.9 | 2.0 | 2.8 | 2.3 | 2.3 | 2.4 | 2.5 | 4.1 | 3.3 | 2.8 | 2.5 | 2.8 |
| Personal Cons. Inflation | 4.4 | 3.1 | 1.1 | 3.2 | 2.6 | 2.8 | 3.0 | 3.1 | 4.1 | 3.2 | 2.3 | 2.8 | 3.1 |
| Residential Construction Inflation | 5.7 | 2.6 | 2.2 | 2.7 | 3.2 | 2.8 | 2.8 | 3.2 | 4.2 | 1.9 | 2.8 | 2.9 | 3.1 |
| Nonresidential Const. Inflation | 0.8 | 3.2 | 3.3 | 3.0 | 2.8 | 3.2 | 3.1 | 3.4 | 0.5 | 1.4 | 2.3 | 3.1 | 3.5 |
| Producer Price Inflation | 4.7 | -5.7 | -5.2 | 1.0 | 2.1 | 3.3 | 3.6 | 4.0 | 2.1 | 0.9 | -1.3 | 2.4 | 4.2 |
| Before Tax Corporate Profit | 234 | 217 | 221 | 240 | 249 | 241 | 235 | 229 | 238 | 225 | 232 | 233 | 243 |
| Corporate Tax Liability | 87 | 80 | 95 | 102 | 114 | 111 | 109 | 107 | 94 | 85 | 98 | 106 | 101 |
| After-Tax Profits | 147 | 137 | 126 | 138 | 135 | 130 | 126 | 122 | 144 | 140 | 134 | 128 | 143 |
| Inventory Valuation Adjustment | -10 | 18 | 5 | -5 | -9 | -12 | -14 | -17 | -5 | -1 | 2 | -16 | -19 |
| Capital Consumption Allowance | 79 | 79 | 85 | 89 | 94 | 98 | 101 | 105 | 41 | 71 | 87 | 103 | 100 |
| Federal Tax Receipts (NIPA) | 804 | 804 | 822 | 839 | 856 | 858 | 863 | 868 | 725 | 785 | 830 | 856 | 880 |
| % of GNP | 19.8 | 19.5 | 19.8 | 19.9 | 20.0 | 19.9 | 19.8 | 19.8 | 19.2 | 19.7 | 19.8 | 19.6 | 18.8 |
| Federal Expenditures (NIPA) | 1030 | 1013 | 1003 | 1010 | 1017 | 1027 | 1037 | 1048 | 898 | 985 | 1011 | 1043 | 1088 |
| % of GNP | 25.4 | 24.6 | 24.2 | 23.9 | 23.8 | 23.8 | 23.8 | 23.9 | 23.8 | 24.7 | 24.1 | 23.8 | 23.7 |
| Deficit(NIPA) | -227 | -209 | -181 | -171 | -161 | -169 | -175 | -180 | -173 | -200 | -180 | -187 | -227 |
| % of GNP | 5.6 | 5.1 | 4.4 | 4.0 | 3.8 | 3.9 | 4.0 | 4.1 | 4.6 | 5.0 | 4.3 | 4.3 | 5.0 |
| % of Net Domestic Savings | 74.4 | 62.0 | 61.6 | 58.9 | 56.2 | 57.5 | 60.2 | 63.1 | 51.1 | 63.5 | 59.8 | 62.8 | 69.5 |

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy
Assumptions and simulations by Dr. Richard Peach, Janemarie Mulvey, and Sean Burns

Table 2

July 1986

## REAL ESTATE AND FINANCIAL MARKETS

| | QUARTERS | | | | | | YEARS | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Actual | | Forecast | | | | Actual | | Forecast | | |
| | 1985.4 | 1986.1 | 1986.2 | 1986.3 | 1986.4 | 1987.1 | 1987.2 | 1987.3 | 1984 | 1985 | 1986 | 1987 | 1988 |
| **REAL ESTATE MARKETS** | | | | | | | | | | | | | |
| Total Single-Family Home Sales (single-family resales and completions) | 4,542 | 4,467 | 4,686 | 4,780 | 4,880 | 4,735 | 4,657 | 4,561 | 3,933 | 4,254 | 4,703 | 4,605 | 4,308 |
| Percent Change -- Year Ago | 18.6 | 11.2 | 14.9 | 9.2 | 7.4 | 6.0 | -0.6 | -4.6 | 5.1 | 8.5 | 10.7 | -1.9 | -6.4 |
| Existing Single-Family Sales (1000's) | 3,500 | 3,257 | 3,471 | 3,580 | 3,670 | 3,601 | 3,571 | 3,508 | 2,866 | 3,214 | 3,494 | 3,526 | 3,202 |
| Percent Change -- Year Ago | 24.4 | 10.3 | 14.0 | 6.5 | 4.9 | 10.6 | 2.9 | -2.0 | 5.7 | 12.1 | 8.7 | 0.9 | -9.2 |
| Dollar Volume (billions) | 318.9 | 307.3 | 348.5 | 369.4 | 371.6 | 356.5 | 378.1 | 386.0 | 247.1 | 291.3 | 349.2 | 369.0 | 348.4 |
| Existing Home Prices - Median ($1000's) | 75.2 | 78.1 | 83.0 | 85.0 | 80.5 | 81.2 | 87.2 | 90.1 | 72.4 | 75.5 | 81.6 | 85.7 | 88.3 |
| Percent Change Year - Ago | 4.5 | 4.6 | 9.9 | 11.0 | 7.0 | 4.0 | 5.0 | 6.0 | 3.0 | 4.3 | 8.1 | 5.0 | 3.0 |
| Monthly Mortgage Payment (P&I, 80%, 30 yr.) | 565 | 543 | 543 | 539 | 494 | 491 | 525 | 538 | 618 | 609 | 530 | 513 | 492 |
| Percent of Median Family Income | 26.1 | 24.8 | 24.6 | 24.2 | 22.0 | 21.7 | 23.0 | 23.3 | 28.2 | 26.2 | 23.9 | 22.3 | 20.6 |
| Housing Starts (1000's) | 1,773 | 1,988 | 1,941 | 1,932 | 1,945 | 1,736 | 1,648 | 1,579 | 1,763 | 1,741 | 1,951 | 1,627 | 1,669 |
| Percent Change -- Year Ago | 10.0 | 12.9 | 11.4 | 14.5 | 9.7 | -12.7 | -15.1 | -18.3 | 3.4 | -1.2 | 12.1 | -16.6 | 2.6 |
| Single-Family Units (1000's) | 1,074 | 1,248 | 1,253 | 1,237 | 1,248 | 1,169 | 1,120 | 1,085 | 1,100 | 1,073 | 1,246 | 1,112 | 1,141 |
| Percent Change -- Year Ago | 2.5 | 13.6 | 17.2 | 16.0 | 16.2 | -6.3 | -10.6 | -12.3 | 3.3 | -2.5 | 16.2 | -10.8 | 2.6 |
| Multi-Family Units (1000's) | 699 | 740 | 688 | 695 | 697 | 566 | 528 | 494 | 663 | 669 | 705 | 515 | 528 |
| 2-4 Family Units (10C)'s) | 80 | 101 | 94 | 95 | 96 | 78 | 72 | 68 | 122 | 93 | 97 | 71 | 72 |
| Percent Change -- Year Ago | -30.7 | 0.0 | -7.7 | 6.4 | 19.8 | -23.5 | -23.2 | -28.9 | 2.8 | 6.3 | 4.3 | -26.9 | 1.4 |
| 5+ Family Units (1000's) | 620 | 639 | 594 | 599 | 602 | 489 | 456 | 426 | 542 | 576 | 609 | 445 | 456 |
| Percent Change -- Year Ago | 37.6 | 13.8 | 3.8 | 9.0 | -2.9 | -23.5 | -23.2 | -28.9 | 7.0 | -23.4 | 5.7 | -26.9 | 2.5 |
| Mobile Homes Shipped | 288 | 262 | 265 | 265 | 269 | 262 | 258 | 255 | 295 | 283 | 245 | 257 | 268 |
| New Single-Family Home Sales (1000's) | 696 | 789 | 772 | 765 | 759 | 680 | 658 | 633 | 637 | 689 | 771 | 645 | 602 |
| Percent Change -- Year Ago | 12.8 | 18.3 | 13.5 | 7.6 | 9.0 | -13.9 | -14.7 | -17.2 | 1.7 | 8.1 | 11.9 | -16.3 | -6.7 |
| New Home Prices - Median ($1000's) | 86.5 | 86.0 | 91.5 | 93.2 | 94.9 | 94.9 | 95.2 | 95.3 | 80.0 | 84.1 | 91.9 | 95.2 | 98.9 |
| Percent Change -- Year Ago | 8.1 | 6.2 | 8.9 | 12.5 | 9.3 | 7.8 | 4.0 | 2.3 | 6.1 | 5.1 | 9.3 | 3.6 | 3.9 |
| New Home Prices -Mean ($1000's, Quality Adj.) | 106.4 | 104.6 | 107.8 | 108.7 | 109.7 | 107.5 | 111.0 | 111.9 | 96.8 | 104.0 | 107.7 | 110.8 | 114.3 |
| Percent Change -- Year Ago | 7.5 | 3.4 | 3.6 | 4.2 | 3.1 | 2.7 | 2.9 | 3.0 | 6.6 | 7.4 | 3.6 | 2.9 | 3.1 |
| NAR Affordability Index | 95.7 | 100.6 | 101.2 | 102.9 | 113.1 | 114.8 | 108.2 | 108.3 | 76.6 | 86.2 | 104.5 | 111.3 | 120.5 |
| Mortgage Debt Outstanding ($ billions) | 2,260 | 2,309 | 2,369 | 2,461 | 2,535 | 2,606 | 2,676 | 2,746 | 1,948 | 2,163 | 2,423 | 2,711 | 2,995 |
| Housing Inventory (millions) | 95.8 | 96.3 | 96.8 | 97.3 | 97.8 | 98.2 | 98.7 | 99.1 | 93.4 | 95.2 | 97.0 | 98.9 | 100.5 |
| Rental Vacancy Rate(%) | 6.7 | 6.9 | 6.8 | 6.7 | 6.7 | 6.6 | 6.6 | 6.5 | 5.8 | 6.5 | 6.8 | 6.6 | 6.4 |
| Office Vacancy Rate (%)<1> | 16.5 | 16.8 | 16.8 | 16.8 | 16.9 | 17.0 | 16.8 | 16.7 | 13.9 | 16.0 | 16.8 | 16.8 | 16.4 |
| Industrial Vacancy Rate (%) <1> | 4.9 | 4.9 | 4.8 | 4.6 | 4.5 | 4.3 | 4.3 | 4.2 | 4.7 | 4.7 | 4.7 | 4.3 | 4.0 |
| **FINANCIAL MARKETS** | | | | | | | | | | | | | |
| Money Supply (M1)(% change) | 11.1 | 7.9 | 16.2 | 8.6 | 7.4 | 5.3 | 3.8 | 4.2 | 7.0 | 9.1 | 11.2 | 6.3 | 4.9 |
| Velocity of M1 (% change) | -6.1 | -2.1 | -10.7 | -2.2 | -1.7 | -1.3 | -0.4 | -0.8 | 3.7 | -3.1 | -5.5 | -1.9 | -0.1 |
| Value of the U.S. Dollar (Trade-Weighted) | 128.2 | 119.5 | 114.0 | 112.0 | 110.9 | 109.7 | 108.6 | 107.2 | 138.3 | 143.2 | 114.1 | 107.9 | 105.9 |
| Percent Change | -28.1 | -24.5 | -17.1 | -6.8 | -4.0 | -4.0 | -4.0 | -5.0 | 10.4 | 3.5 | -20.3 | -5.5 | -1.8 |
| Flow of Funds (NIA Basis) (Billions of dollars,saar) | | | | | | | | | | | | | |
| Sources (total:gross savings) | | | | | | | | | | | | | |
| Private Saving | 694 | 723 | 693 | 697 | 700 | 717 | 723 | 729 | 693 | 694 | 703 | 736 | 800 |
| Personal Saving | 115 | 126 | 110 | 101 | 100 | 114 | 116 | 117 | 173 | 129 | 109 | 122 | 151 |
| Savings Rate | 4.0 | 4.4 | 3.8 | 3.4 | 3.3 | 3.8 | 3.8 | 3.8 | 6.5 | 4.6 | 3.7 | 4.0 | 4.7 |
| Gross Business Savings | 579 | 597 | 583 | 596 | 601 | 604 | 608 | 612 | 521 | 565 | 594 | 614 | 649 |
| Federal Deficit | -227 | -209 | -181 | -171 | -161 | -169 | -175 | -180 | -173 | -200 | -180 | -187 | -227 |
| State & Local | 59 | 65 | 56 | 57 | 58 | 57 | 55 | 53 | 64 | 59 | 59 | 54 | 52 |
| Net Foreign Investment | 153 | 141 | 143 | 140 | 140 | 135 | 134 | 132 | 91 | 115 | 141 | 132 | 116 |
| Uses (total:gross investment) | 681 | 717 | 707 | 722 | 736 | 738 | 743 | 727 | 674 | 669 | 721 | 730 | 738 |
| Nonresidential Investment | 487 | 470 | 471 | 474 | 479 | 478 | 475 | 473 | 430 | 472 | 473 | 474 | 468 |
| Structures | 159 | 162 | 161 | 162 | 163 | 164 | 164 | 164 | 149 | 166 | 162 | 164 | 165 |
| Equipment | 318 | 308 | 310 | 312 | 315 | 314 | 311 | 309 | 282 | 306 | 311 | 310 | 303 |
| Residential Investment | 176 | 180 | 185 | 187 | 187 | 183 | 176 | 170 | 168 | 171 | 185 | 174 | 168 |
| Inventory Investment ($ Billions) | -6 | 35 | 15 | 20 | 25 | 26 | 28 | 26 | 63 | 6 | 24 | 26 | 22 |
| Selected Interest Rates (%) | | | | | | | | | | | | | |
| Mortgage Rates | | | | | | | | | | | | | |
| 30-year Fixed Rate Mortgage | 11.3 | 10.4 | 9.8 | 9.5 | 9.2 | 9.1 | 9.0 | 9.0 | 13.8 | 12.2 | 9.8 | 9.0 | 8.3 |
| Real Mortgage Rate | 8.0 | 7.5 | 7.8 | 6.7 | 6.9 | 6.8 | 6.6 | 6.5 | 9.7 | 8.9 | 7.0 | 6.6 | 5.5 |
| 1-year ARM (without buydown) | 9.6 | 9.2 | 8.1 | 8.0 | 7.9 | 7.9 | 8.0 | 7.8 | 12.6 | 10.1 | 8.3 | 7.9 | 7.9 |
| Real Mortgage Rate | 6.3 | 6.3 | 6.1 | 5.2 | 5.6 | 5.6 | 5.6 | 5.3 | 8.5 | 6.8 | 5.5 | 5.5 | 5.1 |
| Corporate AAA Bond Rate | 10.6 | 9.6 | 9.0 | 8.7 | 8.4 | 8.3 | 8.3 | 8.2 | 12.7 | 11.4 | 8.9 | 8.2 | 7.6 |
| Government Bond Rate | 10.2 | 8.9 | 7.8 | 7.5 | 7.3 | 7.1 | 7.1 | 7.1 | 12.5 | 11.0 | 7.9 | 7.1 | 6.6 |
| Real Government Bond Rate | 6.9 | 6.0 | 5.8 | 4.7 | 5.0 | 4.8 | 4.7 | 4.6 | 8.4 | 7.7 | 5.1 | 4.7 | 4.0 |
| Federal Funds Rate | 8.1 | 7.8 | 6.8 | 6.7 | 6.6 | 6.4 | 6.2 | 6.1 | 10.2 | 8.1 | 7.0 | 6.2 | 6.2 |
| 3-month T-Bill Rate | 7.2 | 7.0 | 6.0 | 5.9 | 5.7 | 5.7 | 5.8 | 5.6 | 9.5 | 7.5 | 6.1 | 5.6 | 5.6 |
| Real 3-month T-Bill Rate | 3.9 | 4.1 | 4.0 | 3.1 | 3.4 | 3.4 | 3.4 | 3.1 | 5.4 | 4.2 | 3.3 | 3.2 | 2.8 |
| 1-Year T-Bill Rate | 7.9 | 7.5 | 6.4 | 6.3 | 6.2 | 6.2 | 6.3 | 6.1 | 10.9 | 8.4 | 6.6 | 6.2 | 6.2 |
| Real 1-Year T-Bill Rate | 4.6 | 4.6 | 4.4 | 3.5 | 3.9 | 3.9 | 3.9 | 3.6 | 6.8 | 5.1 | 3.8 | 3.8 | 3.4 |
| Prime Rate | 9.5 | 9.4 | 8.6 | 8.3 | 8.2 | 8.1 | 8.0 | 7.8 | 12.0 | 9.9 | 8.6 | 7.9 | 7.7 |
| Discount Rate | 7.5 | 7.4 | 6.6 | 6.2 | 6.1 | 5.9 | 5.8 | 6.0 | 8.8 | 7.7 | 6.6 | 5.9 | 5.8 |

<1> Historical Data courtesy of Coldwell Banker
<2> FHA Secondary Mortgage Market Rate

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. Richard Peach, Janemarie Mulvey, and Sean Burns.

## Special Supplement

### The Impact of the Senate Finance Committee Tax Reform Proposal on Commercial and Rental Residential Real Estate

To pay for an aggregate decline in personal tax revenues of roughly $100 billion over five years the Senate Finance Committee proposal would increase the tax burden on income earned from capital assets by an equal amount, with $50 to $60 billion derived from real estate. This higher tax burden on commercial and rental residential real estate would be achieved through the following changes in tax law:

1) The extension of the depreciation period for structures from the current law 19 years, with the option of using either the straight-line or the 175 percent declining balance methods, to 27-1/2 years straight-line for residential properties and 31-1/2 years straight-line for commercial properties. This reduces the value of depreciation deductions over the typical real estate investment holding period by 35 to 50 percent. Depreciation schedules for existing investments would be grandfathered.

2) The repeal of the capital gains exclusion, thereby boosting the maximum capital gains tax rate from 20 percent to 27 percent. This provision would be retroactive in that it would apply to all existing real estate investments sold after enactment as well as those undertaken after enactment.

3) The disallowance of the deduction of losses from real estate investments against income from other sources. Active investors, those who "actively participate" in the management of the property, would be allowed to use losses up to $25,000 to offset other income. However, this $25,000 exception would be phased out for taxpayers with incomes between $100,000 and $150,000. This provision would be phased in over five years but would apply to existing investments. This is particularly onerous and unfair since it does not differentiate between cash flow losses and losses due to depreciation which are just as real but are not incurred out-of-pocket. Moreover, this provision would in effect deny to real estate investors depreciation deductions based on 15-, 18-, and 19-year schedules promised them by law as incentives to undertake the risks of investment.

Table 3 presents estimates of the impact of these proposals on yields provided by commercial and rental residential real estate investments placed in service after enactment of the proposal and the increases in rents or declines in property values that would be required to return yields to current law levels. Impacts are differentiated between commercial real estate, where under current law straight-line depreciation tends to be used, and rental residential real estate, where the 175 percent declining-balance method tends to be used. Impacts are also differentiated between active investors such as sole proprietors or general partners and passive investors such as limited partners since passive investors would face stricter limits on deductions of losses. Estimates are provided assuming 10 percent equity (90 percent loan-to-value ratio) and 25 percent equity (75 percent loan-to-value ratio).

Under the Senate Finance Committee proposal yields on real estate investments would decline at least 20 percent and as high as 50 percent, depending upon the type of property, type of investor, and financing terms. Declines in yields of this magnitude would undoubtedly have a severe impact on the commercial and rental residential real estate markets. The market reaction to these reduced yields could be one of two things: i) either a significant decline in the value of all existing properties with greatly reduced rates of investment in new properties, or

ii) rent increases. Since it is unlikely that rents could rise sufficiently in the short run to return yields to current law levels, the most likely scenario is that values of existing properties would decline and new investment would be cut back. Thus, under this proposal values of existing commercial properties could decline as much as 10 to 20 percent while values of existing rental residential properties could decline as much as 15 to 25 percent.

Table 3
Impact of Senate Finance Committee Proposal on
Commercial and Residential Real Estate Investment
Yields, Required Rents, and Property Values

| | 10% Equity | | |
|---|---|---|---|
| | Decline in Yield | Increase in Rents | Decline in Property Values |
| Commercial | | | |
| Active Investor | -35.6% | +10.0% | -16.5% |
| Passive Investor | -38.4% | +11.6% | -18.8% |
| Residential | | | |
| Active Investor | -46.1% | +14.9% | -22.9% |
| Passive Investor | -48.1% | +16.2% | -24.5% |

| | 25% Equity | | |
|---|---|---|---|
| | Decline in Yield | Increase in Rents | Decline in Property Values |
| Commercial | | | |
| Active Investor | -17.2% | +6.5% | -11.6% |
| Passive Investor | -20.4% | +7.0% | -12.3% |
| Residential | | | |
| Active Investor | -24.0% | +9.8% | -16.4% |
| Passive Investor | -27.5% | +10.2% | -16.7% |

Over time, as the population and the economy grow, the corresponding increase in demand for rental space would interact with the slower increase in supply due to the decline in new investment to boost rents above what they otherwise would be without this proposal. For example, commercial rents would have to rise 7 to 12 percent and residential rents would have to rise 10 to 16 percent to return yields to current law levels.

To put these rent increases in perspective, today the typical renter has an income of about $14,500 while the typical monthly rent is about $350. Under this proposal that typical monthly rent would rise about $35 to $55 for an additional annual payment of $420 to $660. While renters tend to be non-itemizers and so would benefit from a reduced tax burden under this proposal, the annual decline in federal taxes for the typical renter would be about $500. Thus, it is quite likely that the reduced tax burden enjoyed by the typical renter would be totally absorbed by eventual rent increases.